

ID: CCA_2012081016013232

Number: **201311022**

Release Date: 3/15/2013

Office:

UILC: 3121.01-00

From:

Sent: Friday, August 10, 2012 4:01:39 PM

To:

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Subject: Incentive Payments

You asked whether "incentive awards" paid to the named plaintiffs/ class representatives as part of a class action settlement for a suit brought by employees against their employer under the Fair Labor Standards Act (FLSA) constitute wages for employment tax purposes. The incentive awards are paid to the named plaintiffs for their service as the class representatives, and they are a standard category of payment in class action suits. This particular class rep received an award under the settlement agreement, part of which was designated as an incentive award and reported on a Form 1099, and part of which represented back pay reported on a Form W-2. The agent wanted to know whether the incentive award should be reclassified as wages reportable on a Form W-2. The amounts in the settlement to the class members were allocated % to backpay/wages and % to liquidated damages & interest.

There is one unreported case dealing directly with the issue. Trotter v. Perdue Farms, Inc. reviewed the employer's determination that amounts paid as incentive awards to class representatives were wages subject to FICA. 253 F.Supp.2d 812 (D. DE 2003). The court held that the incentive awards were wages subject to FICA reasoning that the underlying claim was wage-based and that the services they rendered as class representatives were an "integral component of the 'entire employer-employee relationship.'" Trotter, 253 F.Supp.2d at 818 (quoting Soc. Sec. Bd. v. Nierotko, 327 U.S. 358, 365 (1946)). It does not appear that the Service had any role in this proceeding.

Our view is that the incentive payments represent remuneration arising from the employment relationship and there is no exception from wages that applies to these payments. We recognize that there is an opposing argument that this is remuneration for services performed in opposition to the employer rather than for the employer and thus is not remuneration for employment. Nevertheless, we still think it is remuneration for employment given its basis in the employment relationship. The broad nature of the definition of wages, and that we are expected to interpret the definition broadly should govern this determination. The payments are made in return for the named plaintiff allowing his name to be used as the name plaintiff and performing the services in connection with being a name plaintiff. These services are to secure rights arising from the employment relationship (i.e., enforcement of the employee's and other employees' FLSA rights) and thus are arguably remuneration for employment. The services are in furtherance of the employment relationship because they are performed to enforce the legally required terms of the employment relationship. The fact that the employer may have opposed the enforcement of those terms does not lessen the fact that the services are performed to further the legal terms of the employment relationship. This can be compared to the employee performing \$100,000 of legal research to determine the amount the employer is required to pay as wages. The employee in effect performed similar services in the context of a lawsuit which was seeking to determine the correct remuneration owed employees in the employment relationship. It is my view that such remuneration is for employment. These payments are made by the employer and there is no separate consideration apart from these services as named plaintiff, which are in furtherance of enforcing the terms of the employment relationship, and thus are wages.

The incentive payments here are part of the overall settlement of wage-based claims, and should be construed simply as the class agreeing to award a higher proportion of the settlement to the named plaintiffs. We look to the origin of the claim to determine the tax treatment of the settlement amounts. Where, as here, the origin of the claim is wage-based, then the settlement amounts are treated as wages unless there is some specific exception. We've recognized exceptions for liquidated damages and interest etc., but I'm not aware of any exception for incentive payments for named plaintiffs who the class has agreed should receive a higher proportion of the settlement amounts based on their services on behalf of the class.

Interest and liquidated damages were taken out of wages by revenue rulings. Rev. Rul. 80-364 provided that court-awarded interest in a back pay suit is excludable from wages. Rev. Rul. 72-268 holds that payments to an employee for liquidated damages under the FLSA are not wages. Interest is a payment for the time value of money. In a situation where the employee receives court awarded back pay and is receiving interest on that back pay, the logic is he or she should have received the money in the years for which the back pay is awarded and at that point would have had the use of the money. The interest is paying the employee as if he or she had invested the wages he should have received when he should have received the wages. One reason the result in the case of court-awarded interest or statutory interest is different from the result in the case of the interest component of deferred compensation (which would be wages when actually or constructively received) is because of the involuntary nature of the deferral of the receipt of the back pay by the employee receiving back pay in contrast to the deferral of compensation under employer plans. Also, here there is an objective standard setting this interest and awarding this amount as interest (usually statutory) as opposed to interest factors that may be used in employer deferred compensation.

Similarly, liquidated damages have been viewed as a penalty on the employer because they apply when the employer's actions merit the liquidated damages not to compensate the employee with back pay. Liquidated damages are designed to punish the employer not to pay the employee for services and apply only when the employee also receives the back pay he or she should have received under the FLSA. Thus, there is some basis for saying liquidated damages and punitive damages are not wages in light of the purpose of the payments to punish the employer rather to provide compensation to the employee.

In contrast, the incentive payments awarded in this case are for services provided by the named plaintiff in the law suit to determine the compensative terms of the employment relationship. The payments are distinguishable from the interest and the liquidated damages. The payments are remuneration for employment and the services performed by the plaintiff come within the broad definition of employment in *Nierotko* and in our cancellation of employment contract revenue ruling. I hope this is helpful.